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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 681

O. D. HARRISON, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (R. 66-73; Pet. App. 12-19) is not officially reported. The opinion of the court of appeals (Pet. App. 1-8) is reported at 304 F. 2d 835.

JURISDICTION

The judgment of the court of appeals was entered on June 22, 1962 (Pet. App. 9-10). A petition for

rehearing was denied on September 27, 1962 (Pet. App. 11). The petition for a writ of certiorari was filed on December 21, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

In 1952, the taxpayers purchased from the issuing company second mortgage bonds with a face value of $404,850, maturing over the next five years. They paid $300,000, leaving an original issue discount of $104,850. At maturity, the company redeemed the bonds by paying taxpayers the face amounts.

The question presented is whether, under Section 117(f) of the Internal Revenue Code of 1939 and Section 1232(a) of the 1954 Code, that portion of the redemption payments representing the original issue discount is taxable as ordinary income, as the court below held, or as capital gain.

STATUTES INVOLVED

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * *

(f) *Retirement of Bonds, Etc.*—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

* * * *

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) *General Rule.*—For purposes of this subtitle, in the case of bonds, debentures, notes or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) *Retirement.*—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) *Sale or exchange.*—

(A) *General rule.*—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

(i) an amount equal to the original issue discount (as defined in subsection (b)), * * *

* * * * *

shall be considered as gain from the sale or exchange of property which is

not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

* * * * *

STATEMENT

The relevant facts were admitted (R. 35-39) and stipulated (R. 61-64, 87-119) and may be summarized as follows (see Pet. App. 3-4, 15-16):

In 1952, taxpayers, three married couples, purchased from Washington-Youree Hotel Company, Inc., second mortgage bonds of that corporation with a face value of $404,850, which were due to mature in series over the next five years. They paid $300,000, leaving an original issue discount of $104,850, or 25.9 per cent of the face value. The bonds on their face (R. 36, 58) provided that if the corporation did not redeem the bonds at maturity it would pay interest thereafter at the rate of 5 per cent. The taxpayers had no interest in the corporation other than their investment in the bonds. They held the bonds until maturity and the bonds were redeemed as they matured until 1957 when the parties agreed to postpone the redemption of a portion of the bonds maturing that year. The corporation amortized the original issue discount over the life of the bonds and deducted the amount allocated to each year as an interest expense.

On their returns for each of the years in question (1953-1957), taxpayers treated as capital gain the excess of the amounts received upon redemption (face

value) over the cost of the bonds (74.1% of face) (R. 4, 9, 14). This treatment was disallowed by the Commissioner (R. 4, 9, 14), and upon payment of the resulting deficiencies, taxpayers filed suits for refund. The actions were consolidated and the district court upheld the taxpayers (R. 66-73). The court of appeals reversed, Judge Brown concurring (Pet. App. 1-6, 6-8).

ARGUMENT

1. The decision below is correct. The taxpayers' contention that the difference between the amount they loaned on corporate mortgage bonds and the amount they received upon retirement of the bonds must be treated as capital gain is directly contrary to fundamental principles of tax law and is not required by the pertinent statutory provisions.

It is settled that the difference between the amount loaned on corporate bonds and the amount received upon the retirement of those bonds, often referred to as the "original issue discount", is a form of interest or compensation for the use of the money. *Commissioner* v. *Morgan*, 272 F. 2d 936, 938 (C.A. 9); *Rosen* v. *United States*, 288 F. 2d 658, 660 (C.A. 3); *Commissioner* v. *Caulkins*, 144 F. 2d 482, 484 (C.A. 6). There is further no question that interest is taxable as ordinary income. *Deputy* v. *duPont*, 308 U.S. 488. It is also a well settled rule that ordinary income, including interest, retains its character as such whether received by itself or as part of the consideration for

the sale or exchange of a capital asset. *E.g.*, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Hort* v. *Commissioner*, 313 U.S. 28; *Commissioner* v. *Phillips*, 275 F. 2d 33 (C.A. 4); *Tunnell* v. *United States*, 259 F. 2d 916 (C.A. 3); *United States* v. *Snow*, 223 F. 2d 103 (C.A. 9), certiorari denied, 350 U.S. 831. Thus, if the bonds in this case had been sold or exchanged by the taxpayers at any time, the amounts received which represented the excess of the face value of the bonds over their original purchase price (the amount loaned) would unquestionably have been taxed as ordinary income, not capital gain. See *Jaglom* v. *Commissioner*, 303 F. 2d 847 (C.A. 2); *First Kentucky Co.* v. *Gray* (C.A. 6), decided November 21, 1962 (10 A.F.T.R. 2d 5984); *United States* v. *Langston*, 308 F. 2d 729 (C.A. 5); *Fisher* v. *Commissioner*, 209 F. 2d 513 (C.A. 6), certiorari denied, 347 U.S. 1014.[1]

In arguing that the original issue discount must be treated as capital gain, taxpayers rely on Sections 117(f) of the 1939 Code and 1232(a)(1) of the 1954 Code (*supra*, pp. 2-3) which provide that "amounts received * * * upon the retirement of bonds * * * shall be considered as amounts received in exchange therefor." Neither the language nor the legislative history of the statutes supports the contention.

Section 117(f) was enacted in 1934 for the

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[1] The *Jaglom*, *First Kentucky*, *Langston* and *Fisher* decisions hold that upon the sale of bonds purchased flat (*i.e.*, without allocation of purchase price between principal and interest), the vendor realizes ordinary income to the extent that the sales price is allocable to interest accrued on the bonds subsequent to their acquisition by the vendor.

purpose of reversing *Watson* v. *Commissioner*, 27 B.T.A. 463,[2] where the Board held that a redemption was not a sale or exchange and therefore that the capital loss provisions of the Code did not apply to such payments.[3] The purpose of Section 117(f) was to assure that payments made upon the redemption of a corporate bond would receive the same tax treatment as amounts received upon a sale or exchange of the bond. Nowhere in the text of the statute or in its legislative history is there any suggestion that it was meant to change the rules by which capital gain is distinguished from ordinary income upon a sale or exchange. See, *e.g.*, *Commissioner* v. *Morgan*, 272 F. 2d 936, 938 (C.A. 9).

2. While the decision below is in conflict with an early decision of the Sixth Circuit, *Commissioner* v. *Caulkins*, 144 F. 2d 482 (1944),[4] we do not believe that review by this Court is warranted to resolve the

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[2] The legislative history of Section 117(f) is set forth in *Commissioner* v. *Morgan*, 272 F. 2d 936, 938-939 (C.A. 9). See particularly Hearings on H.R. 7835, Senate Finance Committee, 73d Cong. 2d Sess. at 76.

[3] Section 101(c) of the 1928 Act defined capital gains and losses as the gains or losses resulting from a "sale or exchange" of capital assets.

[4] In *Rieger* v. *Commissioner*, 139 F. 2d 618 (C.A. 6) and *Lurie* v. *Commissioner*, 156 F. 2d 436 (C.A. 9), cited by taxpayers (Pet. 10, 23) as conforming to the *Caulkins* view, taxpayers' profit on retirement of the obligations merely reflected an upward fluctuation in their market value. No element of ordinary income was involved. In each case, the question for decision, wholly unrelated to the issue presented here, was whether the evidence of indebtedness was in "registered form".

conflict. In *Caulkins* the Sixth Circuit recognized that the portion of the redemption payment representing the original issue discount "is consideration paid for the use of the amounts paid in * * *" and that it was "difficult to perceive any practical reason for taxing increment of the type involved here differently from ordinary income" (144 F. 2d at 484). However, it held that the words of Section 117(f) required capital gains treatment for all gain realized upon the redemption of a corporate bond and rejected the Commissioner's contention that the section "was not intended to cover the gain from interest, but only capital gain" (*ibid.*).

Every court of appeals which has considered the question since *Caulkins* has reached a contrary conclusion, *Rosen* v. *United States*, 288 F. 2d 658 (C.A. 3); *Commissioner* v. *Morgan*, 272 F. 2d 936 (C.A. 9); *Jaglom* v. *Commissioner*, 303 F. 2d 847 (C.A. 2) (expressly approving *Rosen* and *Morgan*), as has the Court of Claims, *Pattiz* v. *United States* (No. 219-61, decided January 11, 1963).[5] The Tax Court in *Gibbons* v. *Commissioner*, 37 T.C. 569, has also accepted the *Rosen* and *Morgan* position, expressly abandoning its prior view (*Caulkins v. Commissioner*, 1 T.C. 656; *Morgan* v. *Commissioner*, 30 T.C. 881). As indicated above, the soundness of the reasoning upon which the decisions of these courts rest is manifest. Moreover, *Caulkins* was decided before this Court's decisions in *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260 and *Hort* v. *Commissioner*, 313 U.S. 28, and the firm establish-

[5] For the convenience of the Court, the *Pattiz* opinion, recently issued, is reprinted as an appendix to this brief.

ment of the principle that ordinary income is not transmuted into capital gain through the sale or assignment of the capital asset which produces it together with the rights to the ordinary income. The widespread acceptance of this principle, even by the Sixth Circuit in other contexts (*Fisher* v. *Commissioner*, 209 F. 2d 513, certiorari denied, 347 U. S. 1014; *First Kentucky Co.* v. *Gray*, decided November 21, 1962 (10 A.F.T.R. 2d 5984); *Shafer* v. *United States*, decided January 11, 1963, affirming 204 F. Supp. 473 (S.D. Ohio)), suggests that if the issue in *Caulkins* were presented to the Sixth Circuit today, that court might well abandon its prior position and follow the rule now accepted in the other four circuits which have considered the question and in the Court of Claims and the Tax Court.

3. Moreover, the question here in dispute is of rapidly diminishing importance, for Section 1232(a)(2) of the 1954 Code (*supra*, pp. 3-4) expressly provides that as to bonds issued after December 31, 1954, any gain realized by a bond holder attributable to original issue discount is taxable as ordinary income.[8]

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[8] The taxpayers' reliance upon this change as indicating that the opposite rule was intended under the 1939 Code is mistaken. The Senate Committee Report stated (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 112):

> Under Section 117(f) of present law, when a corporate or Government bond in registered form or with coupons attached is retired the transaction is treated as a sale or exchange. There is some uncertainty as to the status of proceeds in these transactions, i.e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount (see

Compare *Valley Morris Plan* v. *Commissioner*, No. 447, October Term 1962, certiorari denied, 371 U. S. 922.

CONCLUSION

For the foregoing reasons, we respectfully submit that the petition for a writ of certiorari should be denied.

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FEBRUARY 1963

I.T. 3486, 1941-2 C.B. p. 76, as compared with *Comm.* v. *Caulkins*, 144 F. 2d 482). In these cases, that part of the amount received on a sale or exchange which may represent a partial recovery of discount on original issue is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.

Effective with respect to bonds issued after December 31, 1954, the House bill removes doubt in this area by providing that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income. This is, of course, not intended to have any effect with respect to bonds before that date. * * *

APPENDIX

IN THE UNITED STATES COURT OF CLAIMS

(Decided January 11, 1963)

No. 219-61

OSCAR S. AND LEONA W. PATTIZ v. UNITED STATES OF AMERICA

No. 244-61

ALEX DEUTSCH AND ELEANOR DEUTSCH v. UNITED STATES OF AMERICA

No. 245-61

LESTER DEUTSCH AND BETTY DEUTSCH v. UNITED STATES OF AMERICA

No. 282-61

ROSELLA FAMILIAN, AS TRUSTEE OF THE SONDRA J. FAMILIAN TRUST v. UNITED STATES OF AMERICA

No. 283-61

ROSELLA FAMILIAN, AS TRUSTEE OF THE GARY R. FAMILIAN TRUST v. UNITED STATES OF AMERICA

No. 284-61

ISADORE FAMILIAN AND SUNNY FAMILIAN v. UNITED STATES OF AMERICA

No. 285-61

ISADORE FAMILIAN, AS TRUSTEE OF THE ARNOLD FAMILIAN TRUST v. UNITED STATES OF AMERICA

No. 286-61

ROSELLA FAMILIAN, AS EXECUTRIX OF THE ESTATE OF GEORGE FAMILIAN, DECEASED, AND ROSELLA FAMILIAN, v. UNITED STATES OF AMERICA

No. 287-61

ANNETTE FAMILIAN SHAPIRO v. UNITED STATES OF AMERICA

Arthur B. Willis for plaintiffs. *John P. Lipscomb* was on the briefs.

Cynthia Holcomb, with whom was *Assistant Attorney General Louis F. Oberdorfer*, for defendant. *Edward S. Smith*, *Lyle M. Turner*, *Philip R. Miller*, and *George Willi* were on the briefs.

ON PLAINTIFFS' MOTIONS FOR SUMMARY JUDGMENT AND DEFENDANT'S MOTION FOR JUDGMENT ON THE PLEADINGS

WHITAKER, *Judge*, delivered the opinion of the court:

The issue presented in these cases is whether the difference between the purchase price of registered notes and the price at which the payor redeemed them is ordinary income or a capital gain.

Plaintiff's rely on section 117(f) of the Internal Revenue Code of 1939, as amended, which provides:

> For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidence of indebtednesses issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

In January or February of 1952 taxpayers purchased registered debentures issued by Winco #1, a California corporation engaged in "building and developing of buildings, tracts, and housing developments," at a price equal to two-thirds the debentures' face value. The debentures were all in the following form:

UNITED STATES OF AMERICA

State of California

No. ..... $ .....

Winco #1 Five Year Notes

Winco #1, a corporation organized and existing under and by virtue of the laws of the State of California (hereinafter called the Company), for value received, hereby promises to pay to the registered holder thereof ..... Dollars lawful money of the United States of Ameri-

ca, upon the 1st day of January, 1957, without interest.

The principal hereof is hereby made payable at the head office of Union Bank & Trust Co. of Los Angeles in the City of Los Angeles, County of Los Angeles, State of California.

This note is one of an issue of four hundred ten (410) Winco #1 Five Year Notes, duly authorized in the manner and form prescribed by law, the total principal amount thereof being Three Million ($3,000,000.00) Dollars, all of said notes being of like date, form and tenor, except the variations necessary to express their numbers and denominations * * *.

* * * *

The entire issue of said notes, or any part thereof, are subject to redemption by the Company at any time in the manner and upon the notice provided for in said Trust Indenture, upon the payment of the amounts hereinafter set forth for each One Thousand ($1,000.00) Dollars principal amount of the respective notes:

If such redemption shall occur on or before January 1, 1954, Eight Hundred Eighty Eight ($888.00) Dollars;

If such redemption shall occur thereafter and on or before January 1, 1955, Nine Hundred Twenty Two ($922.00) Dollars;

If such redemption shall occur thereafter and on or before January 1, 1956, Nine Hundred Fifty Five ($955.00) Dollars;

If such redemption shall occur thereafter, the full principal thereof.

The principal of this note and of all said notes may be declared due and payable prior to maturi-

ty in the manner and with the effect provided in said Trust Indenture in case default shall occur as therein provided.

This note shall be registered in the manner and upon the conditions and with the effect as set forth in said Trust Indenture.

This note shall not be valid or become obligatory for any purpose unless and until authenticated by the signature of Union Bank & Trust Co. of Los Angeles, or a successor trustee, upon the Trustee's certificate and registration endorsed thereon, and until authentication by the signature of the Company as to registration.

* * * *

Winco redeemed the debentures purchased by these taxpayers during 1953, paying $888 per $1,000 face value, as provided for in the debentures.

In each case, in their tax returns for the calendar year 1953, taxpayers reported the increment of the redemption price over their original purchase price and paid the capital gains tax thereon. In each case, the Commissioner of Internal Revenue determined that the gain on the redemption of the debentures constituted ordinary income, and assessed a deficiency. In each case the taxpayers paid the assessed deficiency and interest thereon and thereafter filed a claim for refund upon which each lawsuit is based.

The scope of section 117(f) has been before the Courts of Appeals in four different circuits. It first came before the Sixth Circuit in the case of *Commissioner* v. *Caulkins*, 144 F. 2d 482. Caulkins purchased in 1928 a so-called "Accumulative Installment Certificate" in the principal sum of $20,000, payable in ten years on condition that the required payments were made. Caulkins made the payments, which amounted

to $15,043.33, and at maturity was paid the sum of $20,000. The court held that the difference in the amount paid and the amount received was capital gain because of the provisions of section 117(f). Responding to the contention of the Commissioner of Internal Revenue that this was compensation for the use of money, held by the Supreme Court in *Deputy v. DuPont*, 308 U.S. 488, to be interest, the court said:

> Congress might well have made the differentiation urged by the Commissioner, *since it is difficult to perceive any practical reason for taxing increment of the type involved here differently from ordinary income.* The fact that the contract does not provide for equal amounts of interest to be set aside each year, available to the holder, does not affect the question. *The increment is consideration paid for the use of the amounts paid in.* Unfortunately for the Commissioner's contention, Congress has not made the differentiation. [Italics ours.]
>
> * * * *
>
> * * * Clearly $20,000 was the amount received on the retirement of the certificate, and under the plain wording of § 117(f), it was taxable as a capital gain. A provision that the increment in such cases should be taxable under § 22(a) might or might not have been wise and fair; but Congress has not enacted it, and the courts cannot supply it by judicial legislation. Because of the application of the capital gains tax to securities which on their retirement may not result in capital gain, inconsistencies and inequalities may well result from the application of § 117(f). If this is so, the correction of this defect in the operation of the statute is for Congress and not for the courts. * * *

The Commissioner of Internal Revenue acquiesced in this decision from December 1944 to December 1954, when he withdrew his acquiescence.

Another one of these certificates came before the Ninth Circuit in the case of *Commissioner* v. *Morgan*, 272 F. 2d 936. That court refused to follow the *Caulkins* decision. It pointed out that, following the decision of the Supreme Court in *Fairbanks* v. *United States*, 306 U.S. 436, affirming a decision of the Ninth Circuit holding that the gain from the exchange of property for corporate bonds, which were retired by the corporation at par, was not a "sale or exchange of capital assets" and, thus, not a "capital gain", the Congress enacted § 117(f), only to make a retirement equivalent to a sale or exchange. However, it said that the section was not intended to cover the gain derived from the purchase of an original issue of bonds, or of other evidence of indebtedness, at a discount, because the difference between the purchase price and the agreed price at which the bonds were redeemed was compensation paid for the use of money, which was in all respects equivalent to interest, which was taxable as ordinary income under § 22(a), defining gross income. The Tax Court in *Watson* v. *Commissioner*, 27 B.T.A. 463, was in accord.

The Third Circuit came to the same conclusion in *Rosen* v. *United States*, 288 F. 2d 658. We regret we cannot quote extensively from this opinion since we agree with what was said in it.

The Fifth Circuit in *United States* v. *Harrison*, 304 F. 2d 835, 9 AFTR 2d 1848, came to the same conclusion. In that case the taxpayer purchased second mortgage bonds of a face value of $404,850 for $300,000. Among other things the court said:

> As pointed out in the Morgan and Rosen opinions, Section 117(f) was enacted in response to

> Watson v. Commissioner, 1932, 27 B.T.A. 463. Watson held that since the capital gains provisions were tied to the term "sale or exchange", a bond retirement could not qualify. The ruling blocked capital gains treatment in cases where by the underlying tests it would be appropriate; for example, the gain received when a bond purchased at a depressed market price is redeemed at par. The gain realized from such a transaction is a form of capital appreciation that resembles the capital gain received when stock or real estate is purchased and later sold at a profit, in contrast to an original issue discount gain which represents the interest or compensation paid for the use of the money loaned.

The *Harrison* and *Morgan* cases were cited with approval by the Second Circuit in *Jaglon* v. *Comm.*, 303 F. 2d 847, 9 AFTR 2d 1686.

We think this quotation correctly states the sort of gain Section 117(f) was intended to cover and the part it was not intended to cover. It was intended to cover gain derived from appreciation in value, or a case where the purchase was made from some one other than he who issued them at an advantageous price, but certainly not a case where an original issue of bonds or notes were sold at a discount, in lieu of payment of interest on them.

This is the case here. If these notes had been redeemed at their maturity date, the discount would have equalled interest at 10 percent, which is the legal rate in California, the State in which the corporation issuing the debentures was incorporated. For the privilege of redeeming them at an earlier date, the borrower agreed, when the debentures were issud, to pay a premium. We held in *Equitable Life Assur. Soc'y* v. *United States*, 149 Ct. Cl. 316, 181

F. Supp. 241, in an opinion written for the court by Mr. Justice Reed (Ret.), that prepayment charges were "an additional fee for the use of the lender's money for a shorter period of time than originally agreed upon," and that "[t]he charges are part of the compensation to the lender for the use of money." When the debentures were issued, the parties agreed upon the amount to be paid upon the retirement of them at certain stated times prior to maturity. This was the agreed compensation for the use of the purchasers' money for the prescribed periods.

In *Leaven* v. *Comm.*, 37 T.C. 766, the debentures were retired before maturity at a sum agreed upon when they were issued which was ratably higher than the sum payable at maturity. The Tax Court thought the amount agreed upon was compensation for the use of the purchaser's money for the specific period.

We think the discount at which these notes were sold was in lieu of the payment of interest on them, and that the difference in the amount paid for them and the amount at which they were redeemed was ordinary income. In our opinion it was not intended by § 117(f) of the Internal Revenue Code of 1939 to treat it as a capital gain.

The 1954 Code does not affect the transactions in this case. The 1954 Code effected a change in the law. It evidently was not intended as a clarification of Congress' intention when it enacted the Internal Revenue Code of 1939.

The plaintiffs' motions for summary judgment are denied, and the defendant's motions for judgment on the pleadings are granted. Plaintiffs' petitions are dismissed.

DAVIS, *Judge*; DURFEE, *Judge*; LARAMORE, *Judge*; and JONES, *Chief Judge*, concur.

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